Executive Insights

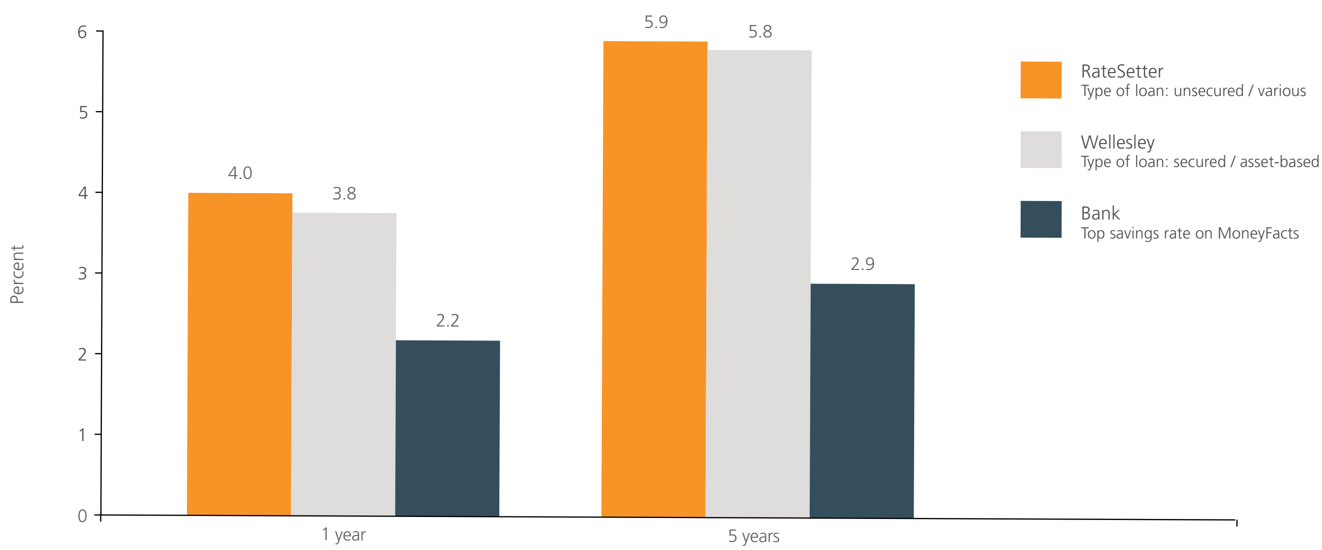
Volume XVIII, Issue 25

Marketplace Lending Is Here to Stay: An Opportunity for Both Current and New Participants

Marketplace lending, also known as peer-to-peer or P2P lending, has grown significantly over the past five years, but remains an alternative finance class in the U.K. We believe it is well positioned for growth and is a relevant strategic consideration for a wide range of businesses as part of a customer-centric growth strategy.

Today's marketplace lending platforms connect borrowers with lenders, or "investors", for a wealth-management type fee, thus disintermediating the traditional lending process. They provide investors with more attractive returns than term deposits in today's low-yield environment; typically, marketplace lending offers two percentage points above the rate of similar-length term deposits from banks (see Figure 1). This is possible for two reasons: first, they have "outsourced" the cost of risk to the investors, meaning

Figure 1
Premium of marketplace lenders over term deposits (examples)



Source: L.E.K. analysis

Marketplace Lending Is Here to Stay: An Opportunity for Both Current and New Participants was written by **Ashish Khanna** and **Diogo Silva**, Partners, and **Nick Morgan**, a Manager in L.E.K. Consulting's Financial Services practice. Ashish, Diogo and Nick are all based in London.

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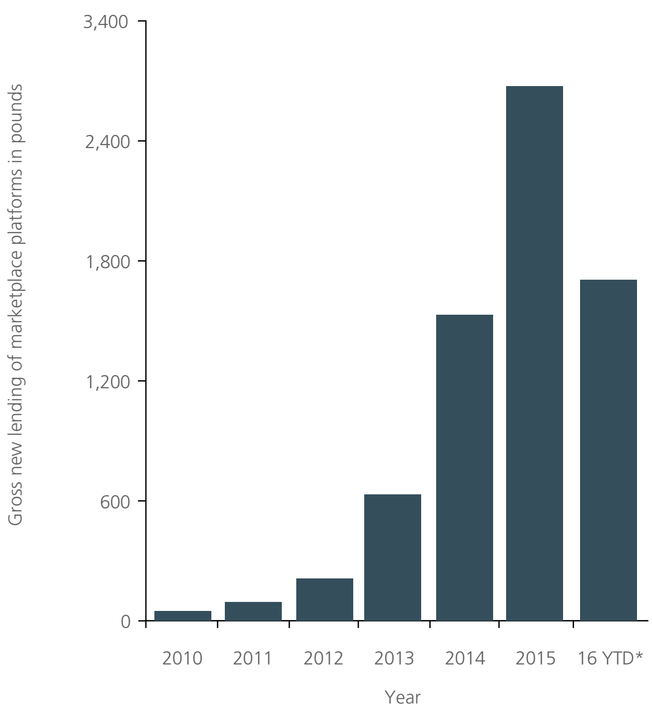
they have no bad debt charges or regulatory capital requirements; and second, they are online businesses with no branch infrastructure, and can operate more cost-effectively than banks when at scale.

Demand growth in marketplace lending has been supported by three key factors:

1. The decision by most banks to selectively shrink their lending businesses has left many customers with fewer places to borrow at competitive rates
2. The public's willingness to support alternative models to "traditional" high street banks, which have developed a reputation for indifferent customer service
3. Smooth, technology-enabled customer journeys and exceptional customer service, which have enhanced the experience for both lenders and borrowers

To date, marketplace lenders in the U.K. — including Zopa, RateSetter and Funding Circle — have facilitated over £7 billion of cumulative lending, with the amount of new lending doubling for three out of the past four years (see Figure 2). Despite this,

Figure 2
Growth of marketplace lending in the U.K.



Note: As of June 2016
Source: Company websites, AltFi

marketplace lending remains a drop in the ocean, accounting for less than 1% of total U.K. lending. We think this market could be significantly bigger.

We also think there are some compelling opportunities for current nonparticipants, even those currently outside of financial services, to be a part of this growth. To succeed, they need a trusted brand, a large and loyal customer base, and a real understanding of their needs and risk profiles.

There are however some important questions that should be addressed before a business or investor seriously considers participating in marketplace lending. Can the market grow to a meaningful size? And can it continue to thrive through an economic cycle? In our view, marketplace lending is both scalable and sustainable.

Why marketplace lending is scalable

To grow, the industry needs both investors and borrowers. Our view is that it will be significantly more difficult to attract good borrowers than it will be to find willing investors.

Investors

In the U.K., retail investors provide the majority of marketplace lending capital (around 70% of new lending in 2015). However, as an investment class, marketplace lending today accounts for less than half a percent of total household deposits, indicating plenty of headroom to expand. Growing consumer awareness and trust, as well as recent regulatory changes to allow direct investment in marketplace lending through Self Invested Pension Plans (SIPPs) and Innovative Finance ISAs (IFISAs), should encourage further retail investment.

The power of institutional investors should not be ignored, and there is growing interest from this group. In the U.S., institutions dominate the scene, and they are starting to support growth in the U.K.. The downside of institutional money is that it is "hot money," which tends to take flight during an economic downturn — a risk most marketplace lenders are well aware of. However, managed appropriately, these investors provide flexible capacity that can help smooth business flows.

Borrowers

The limiting factor on growth has been, and will continue to be, finding more appropriate borrowers — people (or small businesses) that are credit-worthy to the marketplace lender but not served adequately by banks. The factors that attract borrowers are lower interest rates, quicker decisions, product innovation and a smoother (online) application process.

However, building and maintaining underwriting discipline for borrowers is a long and involved process. To accelerate this, some platforms are trying to identify niche markets where they can become the "lender of choice" by knowing more about that segment than others. With varying degrees of success, this ranges from Zopa lending to Uber drivers to Landbay specializing in bridging (short-term) property loans.

Established consumer brands could have a competitive advantage over marketplace lenders here. Those who have access to a large customer base, are trusted and have a rich understanding of their customers have a potentially valuable asset. They would have lower borrower acquisition costs and with the right data might have an underwriting advantage. This could lead to preferential borrower rates for their customers. Brand affinity may also increase the likelihood of borrowers paying back their loans. Participation could be through setting up their own branded platform, or through becoming a valuable partner for an existing marketplace lender looking to offer a "white label" service, of which there are many.

Why marketplace lending is sustainable

To be sustainable, marketplace lending must be able to survive three potential (and possibly interlinked) scenarios: a significant hike in interest rates, the withdrawal of institutional funding and an increase in defaults by borrowers. In all three scenarios, we believe that it can meet the challenge.

1. A significant hike in interest rates

If — and when — interest rates rise and banks start to offer improved rates to depositors, will marketplace lenders still be able to attract the retail investors they need for a sustainable business model? In our view, the answer is yes.

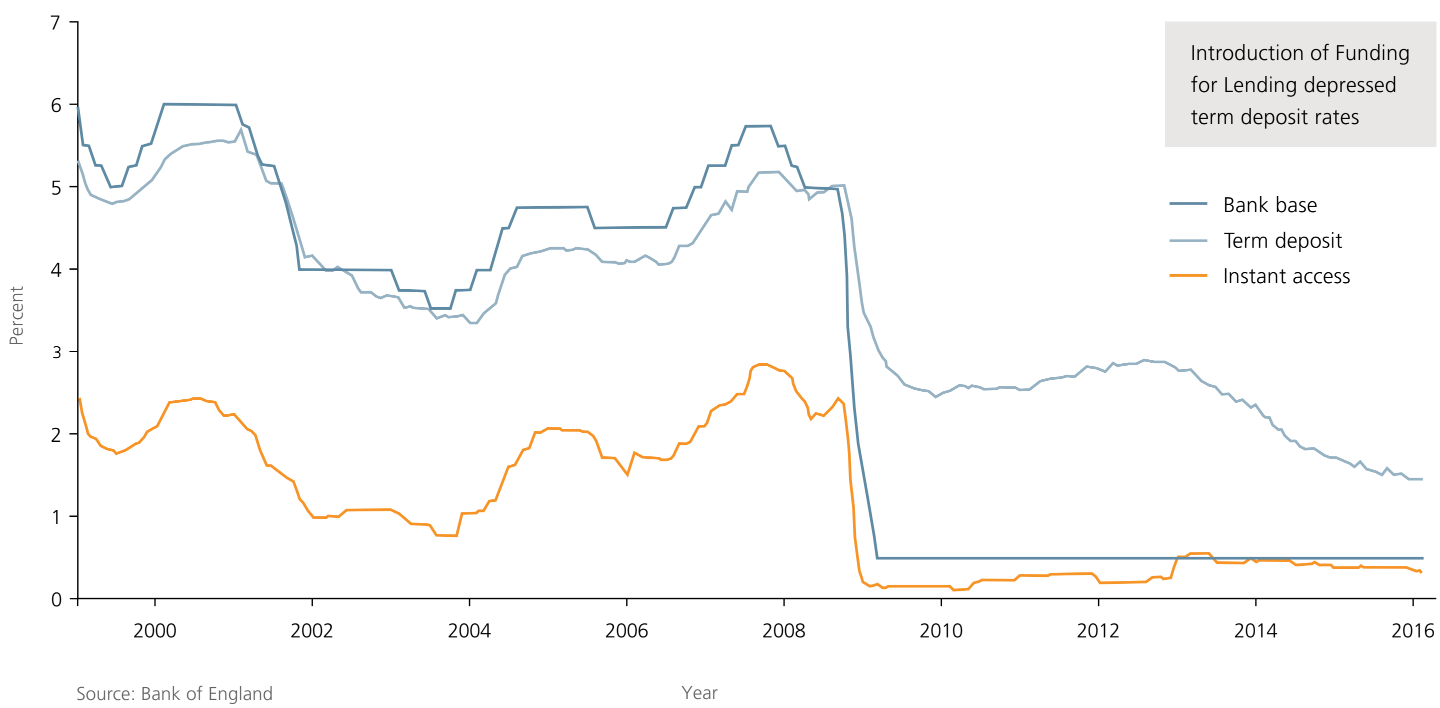
Current interest rate expectations in the U.K. are moderate — with the base rate forecast to remain relatively flat for at least the next few years. Any potential future increase in the base rate will lead to a subsequent increase in term deposit rates. This increase is likely to be at a lower level due to the "Funding for Lending" initiative, which continues (until 2018 at least) to give banks access to cheap funding, depressing term deposit returns (see Figure 3).

Marketplace lenders will still need to offer a premium to remain competitive, but given the likelihood of continued low deposit rates, they should still be able to do so.

2. Withdrawal of institutional funding

In a major downturn, some institutional investors are likely to pull out of new lending. By contrast, investment from retail investors

Figure 3
Retail deposit rates vs Bank of England base rates (Jan. 99-April 16)



Source: Bank of England

tends to be "stickier" and is expected to be more resilient. As long as platforms do not become over-reliant on institutional money, they should be able to withstand the withdrawal of funds from this source. There should also be an opportunity to increase retail investment, because people tend to save rather than spend in a downturn and will hunt for higher-yielding "safe" investments. In the UK, marketplace lenders are well positioned to win some of this investment.

3. Large increases in default rates

If borrowers could no longer service their debts in adverse macroeconomic conditions, marketplace lending platforms would see their default rates rise — and the quality of their historical underwriting would be scrutinized by new investors. Although platforms have set aside risk provision funds or added insurance protection to compensate lenders in the event of business-as-usual defaults, these funds would not provide sufficient coverage if defaults increased significantly. Moreover, even if they are not designed to make marketplace lending a "risk free" investment (they are only intended as a safeguard and are marketed as such), it is unclear to what extent this message has been fully absorbed by investors. However, a major supporting factor is the high level of diversification of lending on most platforms, which should result in an impairment profile not dissimilar to that of banks during a downturn; i.e., the entire investor capital is unlikely to be at risk.

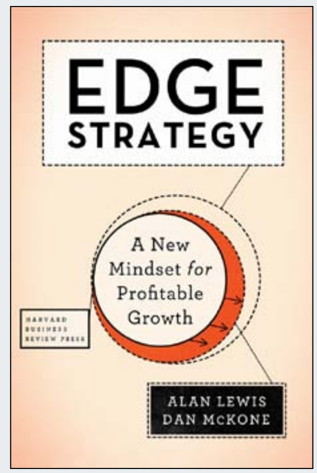
If one or more marketplace lending platforms collapsed as a result of increasing defaults, what would be the wider ramifications on the industry in the U.K.? So far, the industry has proved to be resilient and has survived the failure of a limited number of small platforms — for example, Be The Lender or TrustBuddy. But if one of the larger platforms came under pressure, this could negatively impact the whole industry. Assuming, however, that adequate collections measures can be instituted, it is likely that the majority of lenders' capital would be returned. That being said, such collapses would certainly attract greater attention from regulators, who are already increasingly interested in the expanding industry but have yet to intervene in any significant way.

Opportunity for Both Current and New Participants

Today's large marketplace lending platforms have navigated a "coming of age" phase, but there is much more opportunity to grow, including sophistication in customer lifetime value management and product diversification beyond unsecured loans.

The opportunity for nonparticipants is also considerable. Leveraging existing customer relationships and customer information could create opportunities for achieving lower customer acquisition costs (for both borrowers and investors) and more informed underwriting decisions for borrowers. Affinity with trusted brands could also potentially increase borrower numbers, probability of borrowers making repayments and the "stickiness" of investors.

Whether these companies go it alone or opt to partner with an existing marketplace lender to offer a "white label" platform, we believe marketplace lending should be high on the list of new business opportunities for customer-focused companies. It is growing in popularity, scalable and sustainable, and as established organizations such as Hargreaves Lansdown grow into this space, a precedent has now been set for others to follow suit.



Marketplace lending is well positioned for growth and is a relevant strategic consideration for businesses as part of a customer-centric Edge Strategy®. Edge Strategy is a disciplined, methodical approach for finding low-risk, high-margin revenue opportunities that take advantage of a company's existing products, customers and capabilities. In their recently published book, Edge Strategy: A New Mindset for Profitable Growth (Harvard Business Review Press, January 2016), L.E.K. Managing Directors Alan Lewis and Dan McKone researched nearly 600 companies worldwide across more than 60 industry sectors and found that only about 10% of these companies are successful at exploiting profit opportunities at the edge of their business. Those that do typically outperform their competitors in revenue growth and risk-adjusted shareholder returns, while also enjoying higher customer satisfaction rates. More information about Edge Strategy can be found on our website at http://www.lek.com/capabilities/strategy/edge-strategy

About the Authors

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